

Presentation Public Hearing Worksession

Agenda Item #	1 - 3
Meeting Date	16 July 2007
Prepared By	Sara Anne Daines HCD Director
Approved By	Barbara B. Matthews City Manager

Discussion Item	Proposed Revision of <i>Takoma Park Code Chapter 6.20 Rent Stabilization</i>
Background	<p>The Council will continue its review of proposed amendments to the City's current rent stabilization law with a presentation, public hearing and worksession discussion scheduled for its July 16 meeting.</p> <p>A brief overview of the proposed amendments will be presented by Dr. Baar, to be followed by a public hearing at which time the community will be provided an opportunity to comment. Notice of the hearing has been distributed to local tenants, tenant associations and landlords, posted on the city's web site and published in the July edition of the Takoma Park Newsletter. A worksession is scheduled following the hearing, providing the Council with an opportunity to discuss the proposed amendments and consider comments gathered during the hearing.</p> <p>The more significant changes to the current law include the following:</p> <ul style="list-style-type: none"> • Any rental unit located within a building with one or more housing units would be required to comply with the new law. This would include all rented condominium units. Single rental units located in a two-unit building where the other unit is occupied by the owner or otherwise vacant would be required to comply with the new rent stabilization law unless the rental unit has been specifically approved as an accessory apartment by Montgomery County. • Any unit on a parcel of land which contains only one unit would be exempt from this law, regardless of their ownership. This would generally include single family houses and townhouses. As noted above, the new law would not apply to registered accessory apartments. • The Annual Rent Stabilization Allowance would be increased from 70% of the Consumer Price Index to 100% of the Consumer Price Index (All Urban Consumer all items, Washington-Baltimore). • Capital Improvement and Hardship Rent Increases would be eliminated if the new law were adopted. In its place would be a "Fair Return Petition." Capital replacements would be considered as amortized operating expenses within the Fair Return Petition process rather than as a basis for separate rent adjustments as is currently provided by law. <p>Please note that the proposed ordinance does not provide for a utility surcharge. As</p>

	noted during the Council's FY08 budget discussions, the research required to complete an analysis of the impact of recent increases in utility costs is scheduled to be undertaken this fall. The results of this analysis, and any recommended amendments to the rent stabilization law, will be presented to the Council for consideration at a later date.
Policy	"To complete recodification of <i>City Code Chapter 6.20 Rent Stabilization</i> ." <i>Affordable Housing Policy and Action Plan (July 2005)</i>
Fiscal Impact	N/A
Attachments	<ul style="list-style-type: none"> • Proposed Amendment to <i>Takoma Park Code Chapter 6.20 Rent Stabilization</i> (July 3, 2007 Draft with July 12, 2007 Revisions) • Memorandum Ken Baar (July 3, 2007)
Recommendation	To consider information gathered during the scheduled presentation and public hearing, and to comment on the proposed amendments.
Special Consideration	The first reading of the proposed amendment is tentatively scheduled for July 23 with the second reading to be considered on July 30. If adopted, the ordinance would become effective September 1, 2007.

OUTLINE - Chapter 6.20 RENT STABILIZATION*

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- B. Rents – Rent Increases, Frequency, and Notification Requirements.
 - 1. Rent Increases.
 - 2. Frequency of Rent Increases.
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6.20.020 Buildings exempted from rent stabilization without application for exemption.

- A. Scope of Exemptions.

6.20.030 Rental facilities granted partial exemption from rent stabilization without application for exemption.

- A. Scope of Exemptions.
- B. Frequency of Rent Increases.
- C. Notification Requirements.

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- A. Grant of Exemption.
- B. Termination of Exemption.
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- B. Banking of Unused Rent Stabilization Allowances Authorized Prior to 1992.

6.20.070 Rent escalator clauses.

- A. Rent Increases Permitted by Rent Escalator Clause.
- B. Notification of Rent Increase.

6.20.080 Annual reporting requirements.

- A. Reporting Requirements.
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6.20.090 Rent increases pursuant to a fair return petition.

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 - 5. Consideration of Fair Return Petition by Commission.
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 - 6. Ceiling on Fair Return Adjustments.
 - a. Fair Return Rent Increases on Occupied Rental Units.
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Chapter 6.20 RENT STABILIZATION

6.20.010 Application of rent stabilization -- Scope, rent increases, notification requirements.

A. Application of Rent Stabilization.

The provisions of this chapter shall apply to all residential rental units except as provided herein Sections 6.20.020, 6.20.030 and 6.20.040.

B. Rents – Rent Increases, Frequency, and Notification Requirements.

1. Rent Increases.

Rent increases shall be limited to the rent increase amounts authorized by this chapter for regulated rental units.

2. Frequency of Rent Increases.

The timing and number of rent increases for any regulated rental unit may be implemented only as authorized by this chapter.

3. Notice of Rent Increase.

Notification of any rent increase authorized by this chapter shall be provided in writing to the tenant at least two months prior to the date the rent increase is to take effect.

6.20.020 Buildings exempted from rent stabilization without application for exemption.

A. Scope of Exemptions.

The provisions of this chapter shall not be applicable to the following:

1. Any unit in a licensed facility, the primary purpose of which is the diagnosis, cure, mitigation and treatment of illnesses;
2. Any unit in a facility owned or leased by an organization exempt from federal income taxes pursuant to Section 501(c)(3) of the Internal Revenue Code, the primary purpose of which is to provide temporary sanctuary or shelter for qualified clients, provided that the organization has notified the clients residing in the facility of the temporary nature of their housing at the inception of their residence;
3. Any owner-occupied group house;

4. Religious facilities such as churches, synagogues, parsonages, rectories, convents and parish homes;
5. Transient facilities such as hotels, motels, tourist homes, and bed and breakfast facilities; and
6. School dormitories.

6.20.030 Rental facilities granted partial exemption from rent stabilization without application for exemption.

A. Scope of Exemptions.

The provisions of this chapter shall not be applicable to the following rental facilities except as provided in paragraph B and C of this section:

1. Any building on a parcel of land which contains only one unit; and
2. Any accessory apartment for which the Montgomery County Planning Board has granted a special exception.

B. Frequency of Rent Increases.

The rents for rental facilities and rental units described in paragraph A of this section may be increased only once within a twelve month period.

C. Notification Requirements.

Notification of any rent increase for rental units described in paragraph A of this section shall be provided in writing to the tenant at least two months prior to the date the rent increase is to take effect.

6.20.040 Rental facilities and rental units exempt from rent stabilization pursuant to an application for a grant of exemption.

A. Grant of Exemption.

The Department shall, upon application of the owner, grant an exemption from this chapter for the following rental units and rental facilities:

1. Rental units leased to tenants assisted under federal Tenant Based Assistance Programs under 42 U.S.C. § § 1437f and 11403 et. seq. or similar federally funded rent subsidy

program. However, this exemption shall apply only for so long as the rent demanded does not exceed the authorized Payment Standard, which, for purposes of this subsection, is the maximum monthly rental assistance potentially available to an assisted household before deducting the household share of income paid for rent and utilities as established by the Montgomery County Housing Opportunities Commission or successor agency.

2. Any rental facility that is subject to a regulatory agreement with a governmental agency that controls the rent levels of one or more rental units so that they are available only to low and moderate income tenants.
3. Newly constructed rental units. For a period of five years after the issuance of a rental license, any newly constructed rental units first offered for rent after July 1, 2006.
 - a. Newly constructed rental unit shall mean any rental unit constructed that results in a net gain in the number of rental units at a property over the number of rental units at the property as of July 1, 2006, plus any rental units already added to the property, provided that the size of an existing rental unit or the indoor common areas of the rental facility is not reduced. The reconfiguration, renovation, change in description, or change in identification of a rental unit shall not result in a newly constructed rental unit.
 - b. Replacement rental units not exempt.
 - i. The maximum allowable rents applicable to pre-existing rental units shall be applicable to rental units that replace those units.
 - ii. A rental unit is a replacement rental unit unless the unit is a newly constructed rental unit as defined in this paragraph A.3.a of this section.
 - iii. If a replacement rental unit is smaller than the unit it replaces, the maximum allowable rent for the replacement unit shall be reduced by a percentage equal to the reduction in size of the unit.

B. Termination of Exemption.

1. Exemptions granted pursuant to paragraph A.1 of this section shall expire after one year or when the conditions entitling the facility to an exemption cease to exist, whichever shall first occur. The exemptions are renewable annually upon re-application. Upon the termination of an exemption, the rental unit shall be subject all of the provisions of this chapter.
2. Exemptions granted pursuant to paragraph A.2 of this section shall expire upon the termination of the agreement with the governmental agency entitling the rental facility to the exemption.

C. Rents upon Termination of Exemption.

1. For rental facilities and rental units receiving an exemption pursuant to paragraphs A.1 and A.2 of this section, upon the termination of the exemption, the base rent for the units and the reference point from which the rent ceiling shall be adjusted in accordance with Section 06.20.050 shall be the maximum allowable rent for each unit at the time the exemption commenced plus the annual rent stabilization allowance for each year that the unit was exempt.
2. For rental facilities and rental units receiving an exemption pursuant to paragraph A.3 of this section, upon the termination of the exemption, the base rent for the units and the reference point from which the rent ceiling shall be adjusted in accordance with Section 06.20.050 shall be the rent set forth in the most recent annual rent report for each unit preceding the expiration of the exemption.

D. Frequency of Rent Increases.

The rents of occupied rental units exempt from rent stabilization under this section may be increased once within any twelve month period.

E. Notice of Rent Increases.

For rental units receiving an exemption pursuant to paragraphs A.2 and A. 3 of this section, a landlord shall not increase or attempt to increase the rent for any rental unit without having first given the tenant living therein at least two months' written notice of the increase.

6.20.050 Annual rent increases.

A. Annual Rent Stabilization Allowance.

1. At any point during any twelve month period, commencing on July 1 of each year, the rent of a unit may be increased over the rent charged as of June 30 by the percentage increase in the Consumer Price Index. This increase shall be measured by the percentage increase in the Consumer Price Index-All Urban Consumers all items, Washington-Baltimore (Series ID: CUURA311SAO) from March in the preceding year to March in the current year. The CPI shall be the CPI published as of March in each year.
2. Rent increases which are permitted pursuant to this section but are not implemented may be "banked" in accordance with Section 6.20.060 of this chapter.

B. Frequency of Rent Increases for Occupied Rental Units.

1. Only one rent increase pursuant to paragraph A.1 of this section shall be permitted within a twelve month period.

2. During the pendency of a fair return petition to increase rents above the rent stabilization allowance, rent increases up to the rent stabilization allowance may be taken in accordance with paragraph B.1 of this section. If an additional rent increase pursuant to a petition is subsequently approved by the Commission, the rent increase may be taken pursuant to the terms and the conditions of the Commission's administrative decision and final order.

C. Frequency of Rent Increases for Vacant Rental Units.

1. Rent increases for vacant rental units may be taken prior to the leasing of the rental unit in accordance with paragraphs A.1 and A.2 of this section.

D. Notice of Annual Rent Increases.

1. A landlord shall not increase or attempt to increase the rent for any occupied rental unit without having first given the tenant living therein at least two months' written notice of the increase, except in such a case where a rent escalator clause as provided in Section 6.20.070 of this chapter is contained within the lease.
 - a. If, during the pendency of a notice of a rent increase, the rent stabilization allowance is raised or lowered by the City, a landlord may charge rent up to the rent stabilization allowance in effect on the date the notice was given.
 - b. In any case where a rent escalator clause is contained within the lease, written notice of the rent increase must be given to the tenant not less than one month or more than two months prior to the effective date of the rent increase in accordance with Section 6.20.070(B) of this chapter.
2. Notice of a rent increase shall be in the form and manner prescribed by Department regulations.

6.20.060. "Banking" of authorized annual rent increases

A. Banking of Unused Rent Stabilization Allowances Authorized After 1992.

Notwithstanding the provisions of Section 6.20.050, a landlord may increase the rent for a vacant rental unit by the actual dollar amount of any annual rent stabilization allowances which were not charged to the tenant vacating the rental unit (hereinafter "unused rent stabilization increases"). Such increase may be taken if the rental unit became vacant as a result of a voluntary termination of the tenancy by the tenant or a termination of the tenancy by the landlord for cause. This rent increase may be in addition to any rent stabilization allowance increase which the landlord may impose on or after 12 months from the date of the last rent stabilization allowance increase for that rental unit.

B. Banking of Unused Rent Stabilization Allowances Authorized Prior to 1992.

- a. Before a landlord may increase the rent for a vacant rental unit by the amount of any unused rent stabilization increases for any year or years prior to February 1, 1992, the landlord must submit verifiable documentation to the Department showing that the unused rent stabilization increases were not previously charged to the rental unit. Examples of verifiable documentation are rent ledgers, copies of leases, and rent reports.
- b. The Department must approve such documentation in writing before the landlord may increase the rent for a vacant rental unit by the amount of any unused rent stabilization increases for any year or years prior to February 1, 1992. The required documentation must be submitted 60 days in advance of the date of the proposed rent increase and must include the name and contact information of the tenant vacating the affected unit

6.20.070 Rent escalator clauses.

A. Rent Increases Permitted by Rent Escalator Clause.

For occupied rental units subject to the provisions of this chapter, a landlord may incorporate a rent escalator clause into the lease providing for a rent increase to take effect on or after twelve months from the date of the last rent increase for that rental unit. The rent escalator clause may provide for a rent increase not to exceed the annual rent increase allowance in effect at the time the rent increase is taken and/or the rent increase granted by the Commission pursuant to a fair return petition.

B. Notification of Rent Increase.

No such rent increase shall take effect as a result of a rent escalator clause without the landlord having first given the tenant at least one month, but no more than two months written notice of the rent increase prior to the effective date of the rent increase. Such notice shall be in the form prescribed by Department regulations and shall be provided in addition to any notice of rent increase provided in the lease.

6.20.080 Annual reporting requirements.

A. Reporting Requirements.

On or before September 30 of each year, each landlord shall complete and submit to the Department a rent report for the twelve month period ending on the preceding June 30 on a form provided by and in the manner prescribed by Department regulations.

B. Penalty for Failure to Comply with Reporting Requirements.

Failure to file a complete or accurate rent report by September 30 of each year shall constitute a violation of this chapter unless an extension of time for good cause is granted by the Department.

6.20.090 Rent increases pursuant to a fair return petition.

A. Fair Return Rent Increase.

A fair return rent increase is intended to protect tenants from unwarranted rent increases, while allowing rent levels which provide landlords with a fair return as determined by the Commission and defined herein this section.

B. Standards for Rent Increases Pursuant to a Fair Return Petition.

1. "Fair Return" is defined as "Base Year" "Net Operating Income" adjusted by 50% of the percentage increase in the Consumer Price Index (CPI) from the Base Year until 2007, and 100% of the percentage increase in the CPI since 2007.
2. "Base Year" The landlord may select any of the following as the base year when petitioning for a fair return rent increase:
 - a. 1979, unless the property contains four or fewer rental units.
 - b. 1987, if the property contains four or fewer rental units.
 - c. 1990
 - d. 2000
3. "Current Year" shall either be the calendar year or the fiscal year (July 1-June 30) immediately preceding the date that the application is filed.
4. "Current Year CPI" If the current year is a calendar year, the current year CPI shall be the Annual CPI for that year. If the current year is a fiscal year, the current year CPI shall be the CPI for December within the twelve month period including the fiscal year.
5. "Net Operating Income" equals "Gross Income" minus "Operating Expenses".
6. "Base Year Net Operating Income" may be calculated, at the landlord's option, to equal 40% of the gross income of the rental facility in 1990.
7. "Gross Income" is the annual scheduled rental income for the property based on the rents and fees (other than fees that are reimbursed by the tenants) the landlord was permitted to charge at the time of the application.

8. "Operating Expenses" shall include all reasonable operating and maintenance expenses including but not limited to:

- a. Utilities paid by the landlord, unless these costs are passed through to the tenants;
- b. Administrative expenses, such as advertising, legal fees, accounting fees, etc;
- c. Management fees, whether performed by the landlord or a property management firm;

It shall be presumed that management fees increased by the percentage increase in the CPI between the base year and the current year, unless the level of management services either increased or decreased during this period. Management fees shall not exceed 6% of gross income unless the landlord demonstrates by a preponderance of the evidence that a higher percentage is reasonable.

- d. Payroll;
- e. Amortized cost of capital improvements;

An interest allowance shall be allowed on the cost of amortized capital expenses; the allowance shall be equal to the "average rate" for thirty year fixed rate mortgages, plus two percent. The "average rate" shall be the rate Freddie Mac last published in its weekly Primary Mortgage Market Survey (PMMS) as of the date of the initial submission of the petition.

- f. Self-labor costs computed in accordance with the regulations adopted pursuant to this section;
- g. Property taxes;
- h. Licenses, government fees and other assessments;
- i. Insurance costs;
- j. Reasonable operating and maintenance expenses do not include the following:
 - 1. Expenses for which the landlord has been or will be reimbursed by any security deposit, insurance settlement, judgment for damages, agreed-upon payments or any other method;
 - 2. Payments made for mortgage expenses, either principal or interest;
 - 3. Fines from noncompliance with Housing Code violations or COLTA Orders;

4. Damages paid to tenants as ordered by COLTA or the courts;
 5. Depreciation;
 6. Late fees or service penalties imposed by utility companies, lenders or other entities providing goods or services to the landlord or the rental facility;
 7. Membership fees in organizations established to influence legislation and regulations;
 8. Contributions to lobbying efforts;
 9. Contributions for legal fees in the prosecution of class-action cases;
 10. Political contributions for candidates for office;
 11. Any expense for which the tenant has lawfully paid directly or indirectly;
 12. Attorney's fees charged for services connected with counseling or litigation related to actions brought by the City under City regulations or Title 6, Housing, of this Code, as amended. This provision shall apply unless the landlord has prevailed in such an action brought by the City;
 13. Additional, expenses incurred as a result of unreasonably deferred maintenance; and
 14. Any expense incurred in conjunction with the purchase, sale, or financing of the rental facility, including, but not limited to, loan fees, payments to real estate agents or brokers, appraisals, legal fees, accounting fees, etc.
- k. When an expense amount for a particular year is not a reasonable projection of ongoing or future expenditures for that item, said expense shall be averaged with other expense levels for other years or amortized or adjusted by the CPI or may otherwise be adjusted, in order to establish an expense amount for that item which most reasonably serves the objectives of obtaining a reasonable comparison of base year and current year expenses.

C. Rent Increase Petition Based on Fair Return Standard.

1. Form of Petition.

Whenever a landlord proposes a rent increase of more than the amount permitted by Section 6.20.050 of this chapter, the landlord shall file a petition with the Commission on a form provided by the Department.

2. Required Submission of Income and Expense Information.

The landlord shall be required to submit income and expense information for the two years prior to the current year with the petition.

3. Petition Restrictions.

a. Limitation on the Number of Petitions that may be Filed.

Only one petition for a fair return rent increase shall be filed for a rental facility within any twelve month period unless the Commission finds that exceptional circumstances justify consideration of a second petition within a twelve month period.

b. Consolidation of Petitions.

A petition for a single rental facility must consolidate all requests for rent increases for all of the units within the rental facility that are made within prior twelve month period, unless the Commission finds that there are exceptional circumstances which justify separate petitions within the twelve month period.

4. Adjustments to Petition – Base Year Net Operating Income.

a. Adjustment of Base Year Net Operating Income by Commission.

It may be determined that the Base Year Net Operating Income yielded other than a fair return, in which case the base year Net Operating Income may be adjusted. In order to adjust the Base Year Net Operating Income, the Commission must make at least one of the following findings:

1. Base Year Net Operating Income was abnormally low due to one of the following factors:
 - A. The landlord made substantial capital improvements which were not reflected in the base year rents and the landlord did not obtain a rent adjustment for these capital improvements;
 - B. Substantial repairs were made due to exceptional circumstances; or
 - C. Other expenses were unreasonably high, notwithstanding prudent business practice.
2. Base Year Rents did not reflect market transaction(s), due to one or more of the following types of circumstances:

- A. There was a special relationship between the landlord and tenant resulting in abnormally low rent charges (such as a family relationship);
- B. The rents had not been increased for five years preceding the base year;
- C. The tenant lawfully assumed maintenance responsibilities in exchange for low rent increases or no rent increases; or
- D. Other special circumstances which establish that the rent was not set as the result of an arms-length transaction.

b. Establishment of a New Base Year Net Operating Income – Prior Year Petitions.

The net operating income, income, and expenses, determined to be fair and reasonable pursuant to a prior petition for a fair return rent increase, shall constitute the base year income, expenses, and net operating income in the new petition.

5. Consideration of Fair Return Petition by Commission.

a. Issuance of a Decision by the Commission.

The Commission shall, in good faith, endeavor to issue its preliminary administrative decision ruling on the request within 90 days of the review or hearing on the petition. Upon its determination of the rent increase to be granted to the landlord, the Commission shall issue a decision in accordance with Section 6.24.120 of this chapter and furnish copies of the decision to the landlord.

b. Rejection of Petition.

1. The Commission shall not consider the landlord's fair return petition:

- A. Until the properly completed petition form, including required supporting documentation, has been submitted to the Commission;
- B. When the landlord has not properly registered the rental property with the City and/or when the landlord has outstanding fees or fines with the Department;
- C. When the landlord has not filed required rent reports for the 3 years prior to the filing date of the petition with the Department, provided that the Commission may, at its discretion, waive the above requirement for good cause shown;
- D. When the landlord has failed to comply with a final order of the Commission concerning any rental unit owned by the landlord in the City. However, the

failure to comply with an order of the Commission shall not constitute a basis to decline to consider the landlord's request if the order has been appealed to the Circuit Court and no decision has been rendered on appeal.

2. If the Commission declines to consider the landlord's request it shall provide a written explanation for its action.

6. Ceiling on Fair Return Adjustments.

a. Fair Return Rent Increases on Occupied Rental Units.

If, after the Commission's calculations, rent increases greater than 15% over the increases authorized pursuant to the rent stabilization allowance are necessary to result in the increases approved by the Commission pursuant to paragraph B of this section, the necessary increases shall be phased-in over a term of more than one year until the full increases awarded by the Commission have been taken. If a landlord's required rent increase is phased-in over the term of more than one year, the subsequent rent increases may be in addition to an increase within the rent stabilization allowance in effect in subsequent years.

b. Fair Return Rent Increases on Vacant Rental Units.

If the Commission determines that a rental unit requiring an increase of more than 15% is vacant or if the unit becomes vacant before the required rent increase has been taken in full, the Commission shall allow the required increase for that unit to be taken in one year or upon the vacancy of that unit, provided the unit became vacant as a result of a voluntary termination by the tenant or a termination of the tenancy by the landlord for cause.

7. Notification Requirements.

a. Notice of Petition for a Rent Increase.

The landlord shall provide written notification to each tenant affected by a proposed rent increase within one week after the filing date of the petition. Such notification shall include a copy of the petition form and a listing of all requested rent increases.

b. Notice of a Rent Increase Granted Pursuant to a Rent Increase Petition.

The landlord shall provide written notice to each affected tenant of the rent increase which has been authorized by the Commission, no less than two months prior to the date the proposed increase is to take effect. Said increase shall be contingent on the decision of the Commission becoming final in accordance with Section 6.24.120 and 6.24.130 of this chapter.

8. Rollbacks - Bad Faith Fair Return Petitions.

a. Authority to Require Rollback.

If, upon consideration of a fair return petition, the Commission finds that the adjusted base year net operating income included in the petition is less than the landlord's actual petition year net operating income and the fair return petition was filed in bad faith, the Commission may require the landlord to roll back the rents changed on the rental units covered by the petition to result in a net operating income equal to the adjusted base year net operating income.

b. Purpose of Rollbacks.

The purpose of the rollback provision in this subsection is to ensure that fair return petitions are filed in good faith, that the landlord reviews the records of the rental property for which rent increases are sought to ensure that a rent increase is justified under this section and to balance both the tenant and the landlord interests in each petition to increase rents above the rent stabilization allowance.

c. Definition of Bad Faith.

1. Bad faith can be found, but is not limited to, instances in which the landlord:

- A. listed expenses for repairs or services never performed;
- B. materially misrepresented expenses claimed;
- C. knowingly filed a false rent report, in whole or in part; or
- D. acted in some manner which is a clear abuse of the petition process.

2. The following shall not constitute bad faith under this provision:

- A. Miscalculations and simple mathematical errors; or
- B. Claims for expenses or other items which are not specifically addressed in this section and which the Commission disallowed, but which could plausibly have fallen within this section.

d. Determination of Bad Faith by Commission

The Commission shall verify the information upon which it makes its findings of bad faith and shall issue a decision clearly stating the basis for its finding. The landlords shall be required to notify all tenants affected by the rent rollback, and, if the landlord was permitted to increase rents by the rent stabilization allowance pending a decision

on the fair return petition, all rent increases so collected shall be refunded to the affected tenants within 30 days. If the landlord fails to roll back the rents or fails to refund the rent increases collected, the affected tenants may begin paying the rolled-back rent or may deduct any rent refunds or rollbacks owed the tenants in accordance with paragraph a of this section.

9. Scope of Commission Authority in Setting Rents.

Notwithstanding any other provision of this ordinance or regulations instituted pursuant to this ordinance, the Commission shall be authorized to take into account any factors which it is required to consider by law and grant whatever rent increase is constitutionally required in order to yield a fair return.

10. Burden of Proof.

The landlord shall have the burden of proof in demonstrating that a rent increase should be authorized pursuant to this Section.

From: Ken Baar

Date: July 3, 2007

Re: Revisions to Ordinance

A Draft Rent Stabilization ordinance is enclosed.

The ordinance provides for a “rent stabilization allowance” (annual across-the-board increase) equal to 100% of the percentage increase in the CPI, as opposed to the current 70% standard.

It is contemplated that a study of utility costs will be completed by the staff within the next four (4) months, which would provide information as to whether other increases for specified classes of owners should be considered.

The proposed revisions would continue the underlying fair return concept, under which fair return (fair net operating income) is defined as base period net operating income adjusted by an inflation factor.

However, the proposed and recently adopted revisions also introduce three major changes.

1) A termination of separate passthroughs for capital improvements. Instead, capital improvements would be considered as amortized expenses within the fair net operating income standard.

2) The mortgage payments and other borrowing costs of individual owners would not be considered. This change is based on the view that allowable rent increases should not be dependant on the apartment owner’s particular financing arrangements. Instead, the rent increase standard should be the same for equal size expenditures independent of financing arrangements. A fixed interest would be allowed on capital expenses that are amortized. This interest rate would be determined by a published prevailing interest on fixed rate mortgages at the time the rent increase application is filed.

3) The landlord would have the option of selecting the year 2000 as the base year.

These proposed revisions do not cover the procedural aspects of the fair return rent adjustment process. **An overhaul of the regulations will be necessary as a followup step to the adoption of a new ordinance in order to repeal the sections relating to capital improvement passthroughs and sections relating to the consideration of the financing arrangements of particular owners when determining allowable rent increases pursuant to rent increase petitions.**

The proposed revisions are designed to improve the rent adjustment standard.

As previously indicated, tying allowable rent adjustments to the financing arrangements of individual apartment owners has been struck down by appellate courts in other states on the basis that such distinctions have no rational basis in a rent setting process. Such an approach also opens up the rent setting process to manipulation.

Repeal of separate passthroughs for capital improvements is based on the policy of considering overall income and expenses in the rent setting process, rather than allowing rent increases based solely on individual costs. Other jurisdictions that use this approach (“maintenance of net operating income”) have no provision for the passthrough of the cost of capital improvements that is separate from the fair return process. However, this pattern is far from universal.

If the proposed amendments are adopted, apartment owners will be required to file fair return (formerly known as “hardship”) petitions in order to obtain rent increases in excess of the annual CPI adjustment.

As a consequence of the lack of systematic data on operating cost ratios of Takoma Park apartment owners, it is impossible to project how many apartment owners would file petitions for fair return increases following a repeal of the capital improvement passthrough.

Several factors may offset the potential for rent increases pursuant to fair return petitions.

- 1) Rent increases based on capital improvements have been obtained for a portion of the apartment units in the City, thereby raising the net operating income of these units.
- 2) A significant portion of apartment units may be subject to substantial rent increases upon vacancy.

However, under the policy, in effect since 1992, of limiting annual increases to 70% of the percentage increase in the CPI, if apartment operating costs increased at the same rate as the CPI, most of the annual increases would have been required to cover operating cost increases and NOI would have increased at less than half the rate of increase in the CPI.

Nevertheless, few owners have availed themselves of the fair return (hardship) petition process. On its face, the availability of this process insures that apartment owners can obtain rent increases which are adequate to cover their operating cost increases and obtain some growth in net operating income.

It is possible that more fair return petitions will be filed as a consequence of a repeal of separate increases for capital improvements and that some new issues will emerge. However, once a petition is filed for a building and a fair net operating income determination is made, it will be unlikely that additional petitions will be made for the same building since the 100% of CPI rent stabilization allowance would usually be adequate to maintain the fair net operating income in the future. This

is in contrast to the current provisions under which capital improvement petitions would be continually filed for the same building.

Selecting an “Indexing” Ratio within the Fair Return Standard

In the past few decades, since maintenance of net operating income standards have become common, there has been debate over whether net operating income should be indexed at a fraction or at 100% of the percentage in the CPI.

Advocates and experts for owners of rent controlled properties commonly claim that indexing at less than 100% of the percentage increase in the CPI is not adequate to meet constitutional standards. However, in California, where the maintenance of net operating income standard is widely used, indexing ratios in ordinances vary from 40% to 100% and are commonly in the range of 60% to 75%. The courts have rejected the claim that 100% indexing is constitutionally required.

Discussion of the concept of indexing NOI emerged in California in the early 1980's as peacetime rent controls (as opposed to wartime measures which were seen as only temporary) became widespread in California. In recent years, most of the fair return debate and litigation has been within the context of mobile home park space rent controls which are in effect in about 100 California jurisdictions. (In the context of apartment rent controls, fair return has not been an issue because the apartment rent controls are subject to vacancy decontrol.)

In 1983 and 1984, California appellate courts indicated that freezing net operating income would be confiscatory. In Cotati Alliance for Better Housing v. City of Cotati, a California Court of Appeal ruled that: "If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory."

In Fisher v. City Of Berkeley, the California Supreme Court held that "indefinitely" freezing net operating income is confiscatory. The Court stated:

... although defendants' ordinance may properly restrict landlords' profits on their rental investments, it may not indefinitely freeze the dollar amount of these profits without eventually causing confiscatory results.²⁶

However, it did not define the terms "indefinitely freeze". While the Court did not consider the issue of what rate of growth in net operating income must be permitted, it did indicate that rent controls may "reduce" the value of property, without violating constitutional safeguards. The Court found that:

²⁶ 37 Cal.3d. 644, 683.

Any price-setting regulation, like most other police power regulations of property rights, has the inevitable effect of reducing the value of regulated properties. But it has long been held that such reduction in property value does not by itself render a regulation unconstitutional.²⁷

In two cases, California appellate courts upheld MNOI fair return standards providing for growth in NOI at 40% of the rate of increase in the CPI.²⁸ However, these opinions did not specifically state that less than 100% indexing is constitutional. However, in 2005, in Berger v. City of Escondido, a California Court of Appeal ruled that a rent board's policy of indexing by 40% of the percentage increase in the CPI is constitutional.²⁹

From a policy perspective, there are rationale for indexing at the full rate of increase in the CPI and for indexing NOI at a fraction of the rate of increase in the CPI.

On the one hand, indexing NOI at 100% of the rate of increase in the CPI maintains the real dollar value of the NOI and results in appreciation in the value of a property at the same rate as the CPI, if all other factors remain equal. (In fact, other factors - a decline in mortgage interest rates and increased values of alternative uses (condominiums) - have substantially influenced property values during the past decade.)

On the other hand, under typical circumstances involving typically leveraged (mortgage financed) purchases, 50% indexing would result in equity increasing at a greater rate than the CPI.

In order to simply explain the foregoing phenomenon, the case of a simple house purchase may be used. If a person purchases a house for \$100,000 financed with an \$80,000 loan and \$20,000 cash (original equity), if the house value increases by 20%, up to \$120,000, the homeowner's equity will double from \$20,000 to \$40,000 (the difference between the new value and the purchase loan.)

The following hypothetical is designed to illustrate the impact of 50% indexing on an apartment owner's equity. The NOI and therefore the value of the apartment increases at 50% of the rate of increase in the CPI. However, because 70% of the purchase is financed with a mortgage, the investor's equity increases at a greater rate than the CPI.

²⁷ 37 Cal.3d. 644, 686.

²⁸ Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside, 157 Cal. App.3d. 887 (1983) and Baker v. City of Santa Monica, 181 Cal.3d. 982 (1986)

²⁹ 127 Cal.App.4th 1, 25 Cal. Rptr. 3d. 19 (2005)

**Impact of 50% Indexing on Growth in Investor's Equity
Loan to Purchase Price Ratio 70%**

	Base Year	Current Year	Pct.Increase
CPI	100	150	50%
NOI	200,000	250,000	25%
Property Value	3,333,333* (purchase price)	4,166,667	25%
Mortgage	2,333,333	2,333,333	
Equity	1,000,000	1,833,333	83%

* In this hypothetical the value is computed by dividing the net operating income by a capitalization rate of 6%. Use of a different capitalization rate would not significantly impact the rate of increase in equity.

In the following hypothetical, which is designed to illustrate the impact of 75% indexing on a park owner's equity. The NOI and, therefore, the value of the apartment building increases at 75% of the rate of increase in the CPI. However, because 70% of the purchase price is financed with a mortgage, the investor's equity increases by 125% increase compared to a 50% increase in the CPI.

**Impact of 75% Indexing on Growth in Investor's Equity
Loan to Purchase Price Ratio 70%**

	Base Year	Current Year	Pct.Increase
CPI	100	150	50%
NOI	200,000	275,000	37.5%
Property Value	3,333,333* (purchase price)	4,583,333	37.5%
Mortgage	2,333,333	2,333,333	
Equity	1,000,000	2,250,000	125%

**Impact of 100% Indexing on Growth in Investor's Equity
Loan to Purchase Price Ratio 70%**

	Base Year	Current Year	Pct.Increase
CPI	100	150	50%
NOI	200,000	300,000	50%
Property Value	3,333,333* (purchase price)	5,000,00	50%
Mortgage	2,333,333	2,333,333	
Equity	1,000,000	2,666,666	166%

More highly leveraged investors will realize a greater rate of growth in equity and conversely purchasers who invest a higher percentage of cash will realize a lower rate of growth in equity.

Indexing in the Context of Takoma Park Rent Stabilization

Since 1992, Takoma Park has limited annual across-the-board rent increases to 70% of the percentage increase in the CPI and has defined fair return under the “hardship” standard as base year net operating income adjusted by 50% of the percentage increase in the CPI. 100% indexing of NOI income has only been authorized in the cases in which an owner had no mortgage.

If NOI going back to either a 1990 or 2000 base year is indexed at a higher rate than 50% of the percentage increase in the CPI, this policy would “override” or adjust the rent stabilization allowance policies in effect since 1992, which have limited annual increases to less than 100% of the percentage increase in the CPI.

Since 1990, the CPI has increased by 62%. If it is assumed that NOI was equal to 40% of gross income in the 1990, a 24% rent increase would have been required to provide for growth in net operating income at 100% of the rate of increase in the CPI ($62\% \times 40\% \times 100\% = 24\%$). (This amount is apart from the amount that would have been necessary to cover operating cost increases.)

An increase of half this amount (12%) would have been required in order to permit NOI to increase at 50% of the rate of increase in the CPI. Therefore, a change to 100% indexing for all units would typically result in rent increases in the range of an additional 12% above the amount that would otherwise be authorized for applicants who applied under the fair return (hardship) standard.

If the ordinance is amended to provide for 100% of CPI annual increases in future years, an adjustment of NOI by 100% of the percentage increase any increases in the CPI after June 2007 would be consistent with this approach. The corresponding standard could provide for indexing by 50% of the percentage increase in the CPI up to June 2007 and 100% of the percentage increase in the CPI after June 2007.